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The Internal Revenue Service's Proposed Phased Retirement Regulations: Summary of Comments

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- Current tax law does not explicitly provide for phased retirement programs in defined benefit plans. Certain provisions in the Internal Revenue Code ("Code"), however, may hinder an employer from establishing a formal phased retirement program for defined benefit plans (*i.e.,* the rules for timing of payment, nonforfeitability, suspension of benefits, and nondiscrimination and certain plan designs).

- On November 10, 2004, the Internal Revenue Service ("IRS") issued proposed regulations for "phased retirement" in defined benefit plans. The proposed regulations set out requirements for eligibility and participation in phased retirement programs (*e.g.*, 59 & 1/2 as the eligibility age for phased retirement), distribution rules (*e.g.*, a prohibition on "lump sum" payments), continued benefit accrual, and rules for non-discrimination testing.

- This chart summarizes the comments the IRS received from major employee benefits associations (e.g., ERIC & ABC); major employer associations (e.g., Chamber and SHRM); a major consumer organization (AARP); and other interested parties such as the Chairman and Ranking Member of the United States Senate Special Committee on Aging.

- The IRS has not yet issued a final rule.

The Internal Revenue Service's Proposed Phased Retirement Regulations:[i] Summary of Comments[ii]

Proposed Regulation	IRS' Rationale for Proposed Regulations	ERIC[iii]	ABC[iv]	Chamber[v]	AARP[vi]	SHRM[vii]	Other
<u>Eligibility and Participation Req'ts</u>							
Participation in a phased retirement program must be voluntary.		Request to clarify the term "voluntary" to take into account an employer's business needs because an employer may not be able to accommodate every request for phased retirement.					
Phased retirement benefits payments may not begin before age 59 & ½.	In lieu of a customary phased retirement age, the proposed regulations adopted the 59 & ½ rule because this age is consistent	Age 59 & ½ should be lowered to age 55.	Clarify that age 59 & ½ lifetime annuities are not subject to the 10 % distribution penalty. Using age 59 & ½ will limit the usefulness of phased retirement	Phased retirement programs should be exempt from the age restriction (or at least the age should be reduced).	Age 62 should be the earliest age at which phased retirement benefits may begin to help encourage workers to remain in the workforce.	The age requirement should be eliminated, and only a reduction in hours should be necessary to be eligible for phased retirement.	Age 59 & ½ is too restrictive, and if a plan offers early retirement at age 55, phased retirement beginning at age 59 & ½ would be removed for a large proportion of the population.

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	with Code sections 401(k) and 72((t)(3)(B).		programs because employees instead will elect early retirement and go to work part-time for another employer. Phased retirement benefits should be allowed at any age, years of service or combination of age and service that is allowed under the terms of the plan				WW.[viii]
Only individuals who were full-time employees immediately before phased retirement may participate in a phased retirement program.		Allow part-time employees to participate in phased retirement programs by revising the regulations to allow phased retirement upon a specific event (<u>e.g.</u> a reduction in work schedule and reaching a certain age) rather					It is unclear what constitutes full-time employment in many industries that participate in multiemployer plans, and, therefore the regulations should clarify that full-time work may be determined by

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		than status as full-time versus part-time.					reference to the employment patterns in the industry in which the employee works. NCCMP.[ix]
Requires that the work reduction percentage be at least 20% of the full-time schedule based on an hours counting method.		The plan's ability to make a phased retirement distribution should be based on a specified event (such as reaching a certain age and a reduced schedule) rather than on the employee's status as part-time. This is complex and restrictive because hours of service are not recorded for many employees.	A facts and circumstances test may be more appropriate in the determination of "partial retirement". This is complex and restrictive because hours of service are not recorded for many employees.	Employers should be able to establish their own work reduction percentage.		This may not be appropriate for salaried workers because employers often do not keep track of hours worked for salaried employees.	In determining the 20 % reduction, the regulations should clarify that in industries in which work is characterized by short term employment and the levels of work fluctuate, the plan can determine what is full-time employment by reference to the employment patterns in the industry in which the employee works. NCCMP. Offer a safe harbor phased retirement option where if an

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							employee's work schedule or responsibilities are materially reduced in a manner mutually agreeable to the employer and employee, a 20% phased retirement benefit could be offered. NAFCU.[x] Alternatively, the retirement benefit could be based on the reduction in pay rather than the reduction in hours. NAFCU, CUNA.[xi] The exact hours counting are administratively complex and burdensome because many defined benefit plans do not track hours (especially for salaried employees).

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							Senate Aging Committee[xii]
Key employees must be excluded from phased retirement programs.				Key employees should be allowed to participate in phased retirement programs.			
Phased Retiree Employment/Retirement Status							
A phased retiree will be in "dual status" – partially retired and partially employed.	The dual status approach is the most consistent with the policy goal that benefits be maintained primarily for retirement.						This concept should be deleted because it will lead to onerous administration requirements for qualified pension plans by requiring the plan administrator to constantly monitor the individual's status to be eligible to continue to receive a distribution rather than merely on the occurrence of

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							a one time event. WW The dual status may also raise concerns and encourage coverage challenges under other employee benefit plans, such as active or retiree health plans. WW.
<u>Distributions</u>							
Prohibition on lump sum distributions.	This prohibition is necessary to prevent the premature distribution of retirement benefits.	Lump sum payments should be allowed because by not allowing this form of distributions, if a lump sum distribution is allowed under the plan for other types of retirement, limits on lump sum distributions will make phased retirement less desirable.	Lump sum payments should be allowed.	Lump sum payments should be allowed.	Lump sum payments should not be allowed.		Should allow only for de minimis amount. AAA.[xiii] Lump sum payments should be allowed. WW.

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		Alternatively, allow phased retirement programs to make eligible rollover distributions after the employee reaches a retirement age at which the employee could typically receive a lump sum distribution or other eligible retirement distribution.					
All early retirement benefits, retirement-type subsidies and optional forms of benefits available upon full retirement must be available under a phased retirement program.		The regulations should clarify that Social Security supplements do not have to be distributed as part of a phased retirement program.	An employer should have the option of offering the early retirement subsidies as part of a phased retirement program otherwise the phased retirement program could be too expensive.	Allow employers to restrict benefit options for phased retirement to a single or joint and survivor annuity.	The proposed regulations should retain the protections on early retirement subsidies.		
The amount of a phased benefit must be consistently proportional to the reduction in hours worked.		The pro-rata hours-counting method is unsuitable for		Noting that this requirement may require			Threshold could be based on scheduled hours (rather than

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		plans that do not track hours of service. Suggesting that the amount of payment be based on a table based on the estimated reduction in work schedule or a compensation reduction approach. The hours counting method is inappropriate for salaried employees.		recalculation each time hours are reduced, requests that the regulations limit the number of times phased retirement benefits must be recalculated to once a year.			actual hours) or base compensation. Alternatively, base phased retirement benefits on percentage of time worked. AAA. A plan should be allowed to distribute any portion of the accrued benefit as a phased retirement benefit. WW The final regulations could allow for alternatives such as use of an employee's daily work schedule reduction; allow use of ranges of an employee's expected reduction to determinate the amount of payment; or allow

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							for a comparison of an employee's compensation immediately before and after entering into the program. Senate Aging Committee.
An individual may not elect a retroactive annuity starting date that starts before the earlier of the date the individual could have otherwise begun receiving benefits.		Expecting that the annuity starting date regulations be interpreted to conform to the phased retirement regulations so that a retroactive annuity starting date could be elected with respect to a phased retirement benefit.					
<u>Plan Participation</u>							
An individual who elects phased retirement must be entitled to participate in the plan in the same manner as if the employee were still maintaining a full-time schedule (including the calculation of average earnings), and upon full retirement, the employee must	The requirement that full-time compensation be imputed, with a proportionate reduction based on the	The regulations should be revised to provide that the employee's benefit accruals, if any, should be based on actual compensation, service and job			The regulations should retain the provision that mandates that an individual's compensation will be deemed to be the compensation		Requiring plans to impute and annualize compensation for phased retirees would require some plans to establish separate

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be entitled to the same benefits that a similarly situated employee who did not elect phased retirement would be entitled to, except that years of service during the phased retirement period are prorated based on either hours of service or compensation.	employee's actual service, is intended to ensure that a participant is not disadvantaged by reason of choosing phased retirement.	position. Further, an individual who is working part-time under a phased retirement program should accrue benefits at the same rate as a part-time employee who is not participating in a phased retirement program. Furthermore, if an individual is employed during a phased retirement program in a position not covered by the plan, no additional accruals should be required.			prior to entering a phased retirement program for benefit calculation for final average pay plans.		procedures that only would apply to a small portion of the plan's population and might result in a windfall to participants. WW.
<u>Phased Retirement Benefit Testing</u>							
A plan administrator must annually compare the actual hours worked and the amount of the phased retirement benefit received. No comparison is required for the first two years of an individual's phased	The comparison testing is to ensure that employees in phased retirement are	The comparison testing should be triannual rather than annual. The two year rule should be	The comparison testing should be triannual rather than annual. This provision		The annual review will ensure that the phased retirement program is a bona fide	This requirement should be eliminated because it is administratively burdensome,	The annual testing requirement cost could outweigh the benefit of a phased retirement

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retirement if an employee has entered into an agreement with the employer to fully retire within 2 years and the employee fully retires. No comparison is required for any phased retirement testing period ending within three months before the employee's normal retirement age or anytime after.	in fact working at the reduced schedule, "as expected."	changed to three years and supplemented by a rule that provides that no comparison is required if the employee is within three years of eligibility for unreduced Social Security retirement. The three month rules should be changed to a 1 year rule.	should be deleted because many employers do not track hours, and many defined benefit plans are administered by third party administrators who may not have access to such data.		program and maintain the balance between pension distributions to salary.	and it may be cost prohibitive for some organizations.	program. NASRA/NCTR[xiv], WW. The final regulations could require audits less frequently or broaden the exceptions. Senate Aging Committee.
<u>Non-Discrimination Testing</u>							
Phased retirement benefits will be considered a benefit, right or feature under Treasury Regulations Section 1.401(a)(4)-4. Therefore, phased retirement benefits would need to be made available in a nondiscriminatory manner to both Highly Compensated Employees and Non-Highly Compensated Employees; however, age and service limitations are disregarded if there is no time limit for electing the benefit.		These requirements are too complex and may prevent employers from implementing a phased retirement program. The age and service requirements for phased retirement should be disregarded in determining whether it is	A facts and circumstances test under Code Section 401(a)(4) is appropriate for a phased retirement program to encourage their development and to allow employers to implement phased		The final regulations should ensure that the Code's nondiscrimination rules apply to phased retirement benefits to extend protection to Non-highly Compensated Employees and help guarantee that a broader	These requirements should be relaxed.	A facts and circumstances test (including for example, the criticality of the business skills of the affected employees to the employer) under Code Section 401(a)(4) is appropriate for phased retirement program to

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		currently available to an employee.	retirement programs on a trial basis.		spectrum of participants are eligible for such benefits.		encourage their development and to allow employers to implement phased retirement programs on a trial basis. WW.
If an individual was a Highly Compensated Employee before entering a phased retirement program, the individual will be treated as a Highly Compensated Employee for testing purposes while participating in a phased retirement program.	To be consistent with the requirement to use full-time compensation during the phased retirement period in computing final benefits, an employee who was a Highly Compensated Employee before beginning phased retirement benefits would be treated as a Highly Compensated Employee	The status of an individual in a phased retirement program should be based on the individual's actual compensation during the phased retirement program.			This requirement should remain in the final regulations.		

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	during phased retirement.						
<u>Full Retirement Benefit</u>							
The form of the phased retirement benefit must be maintained for that portion upon full retirement.	This requirement is consistent with the fact that the phased retiree is in dual status. In addition, this approach ensures that a phased retirement program offers an early retirement benefit.			Request that the full retirement benefit should be calculated without regard to the phased retirement benefit elected, with a present value of the phased retirement benefit subtracted from the final benefit.			
An employee's total accrued benefit is offset by the portion of the employee's phased retirement accrued benefit that is being distributed as part of a phased retirement benefit at the time of full retirement.							If the intent of this reduction is to reduce the total value of the benefit by the actuarial equivalent of the amount that was previously paid, the reduction should include all amounts paid

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							(including early retirement subsidies) and the regulations do not adequately address this in the context of cash balance plans. NAFCU, CUNA. The benefit calculation should be eliminated so long as the final retirement benefit does not result in a reduction in the participant's accrued benefit and the method for making the determination is disclosed to the participant before entering the phased retirement program. WW.
A phased retiree has the same range of benefit options upon full retirement as similarly situated employees who did not					This provision should be retained in the final regulations		

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elect phased retirement.					so as not to undercut the voluntary nature of a phased retirement program and to preserve the inviolability of the pension plan.		
Normal retirement age "cannot be earlier than the earliest age that is reasonably representative of a typical retirement age for the covered workforce."	This requirement is necessary so that normal retirement age is not set so low as to be a subterfuge to avoid the requirements of Code Section 401(a) and to protect employee benefits. It is not the IRS' intent to target plans that set their normal retirement age at 60 or 62.	This section should be withdrawn because it (a) conflicts with current law; (b) conflicts with the Code's anti-cutback rules; (c) imposes a vague, unclear and inadministratable legal standard; and (d) punishes cash balance plans.	Recommends that this provision not be adopted because it could impact all retirement plans, and not just those that include phased retirement benefits. In addition, plan sponsors may have a problem understanding and applying this rule. Finally, were this adopted, many current plans would violate this provisions.	Concerned that this provision is beyond the IRS' authority because the Code already defines normal retirement age.	Age 62 should be the normal retirement age because it reflects the average age of actual retirees. This age could be lowered in the future if the implementation of the final regulations reveals the need to do so.		Description "reasonably representative" is unclear, and guidance is sought on how such an age can be determined within small companies, new companies with no history of retirement age, organizations with a diverse workforce in which retirement ages vary depending on job classification and physical job demands. AAA. Recommends that this provision not be adopted.

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							ASPPA.[xv] This provision adds ambiguity to the qualification requirements and adding it may be outside of the IRS' authority. WW. This standard is vague, and many employers have stated that they are unsure how to apply it. Senate Aging Committee.
<u>Miscellaneous</u>							
	The proposed regulations do not address when a full retirement occurs and specifically do not endorse a prearranged termination and rehire as constituting a full retirement.				Concern that employers could use phased retirement programs to force older workers out of full-time positions earlier than the older worker would prefer.	The proposed regulations provide that phased retirement benefits are subject to the Code's anti-cutback rules, which means that an employer may not be able to	The regulations should address the conditions under which a participant's benefit may initially be limited under Code Section 415 and what happens during a phased retirement period as the limits

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	The proposed regulations only address certain tax issues, and do not address other issues such as potential loss of eligibility for health plan coverage or any potential age discrimination issues.					modify such a program to reflect changes that have occurred in the workplace.	increase. AAA. Safe harbors under the ADEA should be established. AAA. Safeguards should be established regarding the practice of rehiring retirees and when such an individual incurs a bona-fide termination. AAA. The regulations should allow an employer to establish temporary phased retirement programs and should clarify that a plan is permitted to eliminate phased retirement options. CUNA.

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							The IRS should clarify that phased retirement arrangements can be adopted on a "window" basis for a specific number of years. WW.

[i] See 65 Fed. Reg. 65108 (Nov. 10, 2004) and 69 Fed. Reg. 77679 (Dec. 28, 2004).
[ii] This chart is a summary of the comments that were available on the Internet. This does not include all comments that the Internal Revenue Service received.
[iii] ERISA Industry Committee. Advocacy organization for major employers (members must have at least 5,000 employees) for employee benefit issues.
[iv] American Benefits Council. Advocacy organization for employers that sponsor employee benefit plans. In addition, ABC provides technical assistance to lawmakers, the media and other industry trade associations.
[v] United States Chamber of Commerce. Association representing national businesses and their interests.
[vi] American Association of Retired Persons. Organization representing individuals over the age of 50.
[vii] Society for Human Resource Management. Organization representing individual human resources specialists.
[viii] Watson Wyatt. Global consulting firm specializing in human resources management and employee benefits.
[ix] National Coordinating Committee for Multiemployer Plans. National organization devoted exclusively to protecting the interests of individuals who rely on multiemployer plans for retirement, health and other benefits.
[x] National Association of Federal Credit Unions. Trade association representing the federal credit unions.
[xi] Credit Union National Association. Trade association for credit unions.
[xii] United States Senate Special Committee on Aging.
[xiii] American Academy of Actuaries. A nonpartisan, public policy organization for actuaries of all specialties within the United States. AAA also sets qualification standards and standards of actuarial practice.
[xiv] National Association of State Retirement Administrators and National Council on Teacher Retirement. NASRA members are the directors of state, territorial and public retirement system. NCTR members include 75 state and local government retirement systems that include teachers.
[xv] American Society of Pension Professionals and Actuaries. National society of retirement plan professionals with a mission of educating pension professionals and preserving and enhancing the private pension system.